No. 93-214

Supreme Court, U.S.
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In the Supreme Court of the United States

October Term, 1993

FRANK L. BRYANT, KEMPER SECURITIES, INC., a Delaware Corporation (formerly known as BATEMAN-EICHLER, HILL RICHARDS, INC.), CHARLES R. HEMBREE, and KINCAID, WILSON, SCHAEFFER & HEMBREE, P.S.C., a Kentucky Corporation,

PETITIONERS,

v.

GEORGE E. LAYMAN, JR. DBA FOREST ACRES PARTNERSHIP, a Washington State Partnership, BARRY K. SCHWARTZ and CALVIN KLEIN DBA BARRY K. SCHWARTZ PARTNERSHIP, a New York Partnership, ZENYA YOSHIDA DBA SHADAI FARM, KENNETH FRANZHEIM, II, H. JAMES GRIGGS, EARL H. SHULTZ, BLAS R. CASARES, RICHARD L. SCHULTZ, VIRGINIA M. McGONIGLE, JOHN F. McGONIGLE, and ROBERT D. STRATMORE,

RESPONDENTS.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether, in applying California state law applicable to the construction of contracts, the Court of Appeals properly affirmed the district court's interpretation that, under a contract executed by respondents to subscribe to purchase private placement stock, respondents did not agree to indemnify the sellers for attorneys' fees in the event that respondents should unsuccessfully sue the sellers for violation of the federal securities law.

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B. Statement of facts.

1. The private placement of Spendthrift stock.

Spendthrift Farm, based in Lexington, Kentucky and recognized as one of the world's leading thoroughbred horse farms in the 1970's and early 1980's, was founded, owned and operated by Leslie Combs and his son, Brownell Combs. In early 1983, the Combses devised a plan to sell $35 million worth of their own Spendthrift stock in a private offering and, shortly afterward, raise an additional $30 million for the company in a public offering. The Combses hired petitioners Charles Hembree and Kincaid, Wilson, Schaeffer & Hembree (hereinafter the "Kincaid firm") as securities counsel, petitioner Frank Bryant as a consultant to advise on the private and public stock offering, and Kemper Securities, Inc. (formerly Bateman Eichler, Hill Richards, Inc.) to review the private offering and underwrite the public offering.

Beginning in April 1983, the Combses offered their Spendthrift stock in 20 equal units, each valued at $1.75 million, to investors around the world. The Combses' stock was not registered with the Securities and Exchange Commission (hereinafter the "SEC"). Instead, the Combses represented to respondents and other investors that the offering was a "private placement," exempt from registration under section 4(1) of the Securities Act of 1933

(15 U.S.C. § 77d) and Regulation D (17 C.F.R. § 230.501, et seq.) promulgated thereunder.[1]

In order to comply with the private placement exemption, the Combses had to ensure that investors satisfied the "sophistication" requirements of Regulation D. These requirements include, inter alia, a minimum net worth, knowledge and experience in investment matters, a capability of evaluating the risks and merits of the investment, access to the issuer's books and records, a purchase with no view to resale, and an opportunity to ask questions and receive answers. See 17 C.F.R. §§ 230.501, 502 & 506 (Resp App. at A2-A18).

During the spring and summer of 1983, the Combses sent an offering prospectus, entitled Private Placement Memorandum (hereinafter "PPM"), to respondents and other prospective investors. The PPM provided that:

> SUITABILITY STANDARDS: The Sellers will impose certain standards which prospective investors must meet in order to be eligible to purchase the shares. These suitability standards are designed to assure compliance with section 4(1) of the Securities Act of 1933 and Regulation D promulgated by the Securities

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1 Section 4(1) of the Securities Act of 1933 (15 U.S.C. § 77d(1)) and Regulation D (17 C.F.R. § 230.501 et seq.) are reproduced, in relevant part, in Respondents' Appendix (hereinafter "Resp App.") at pages A1-A18.

> and Exchange Commission thereunder and with the Blue Sky Laws of the states in which this offering will be made.
>
> . . . .
>
> In order to ensure compliance with the foregoing suitability standards, each prospective purchaser will be required to execute a Subscription Agreement (a copy of which appears in this offering memorandum as Appendix D-4) containing a representation that he meets the suitability standards.[2]

By signing the Subscription Agreement, each investor represented, inter alia, that the investor (1) was financially able to bear the economic risk of the investment, (2) had a net worth in excess of $5 million, (3) had read the PPM, (4) had an opportunity to review Spendthrift's books and records, (5) was capable of

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2 Similarly, the Purchaser Questionnaire completed by each investor provided that:

> The information contained herein is being furnished to Leslie Combs II and Brownell Combs II, the sellers of shares in Spendthrift Farm, Inc., a Kentucky Corporation, for the purpose of determining whether the undersigned's subscription for shares in the Company may be accepted pursuant to Section 4(1) of the Securities Act of 1933, as amended (the "Act"), and Rule 506 promulgated by the Securities and Exchange Commission thereunder ("Rule 506"). The undersigned understands that (i) the sellers of the shares will rely upon the following information, (ii) the shares will not be registered under the Act in reliance upon the exemption from registration provided by Section 4(1) of the Act and Rule 506, and (iii) this Questionnaire is not an offer to sell nor the solicitation of an offer to buy any of the shares, or any other securities, to the undersigned.

evaluating the risks and merits of the deal, (6) was given an opportunity to ask questions and receive answers from the Combses, and (7) was purchasing shares for his own account and not with a view to resale. See Pet App. at A73-77.[3]

The Subscription Agreement expressly recited that the Combses were relying upon the subscribers' representations for the registration exemption. Id. at A75. And each respondent further represented that:

> [H]e understands that in [sic] view of the Securities and Exchange Commission (the "Commission") the statutory basis for the exemption claimed would not be present if, notwithstanding each investor's representations and warranties, any of the investors has in mind merely acquiring any of the Units for resale upon the occurrence of [sic] non-occurrence of some predetermined event or if any investor is not financially responsible.

Id.

The indemnity clause, the interpretation of which was at issue below, followed. It provided in full that:

> The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber

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3 Prior to 1982, private stock offerings exempt from registration under the federal securities law were governed by SEC Rule 146. In 1982, the SEC adopted Regulation D, which defines an accredited investor, inter alia, as an IRC 501(a)(3) tax-exempt organization with total assets in excess of $5 million or an individual with a net worth in excess of $1 million. 17 C.F.R. § 230.501(a) (Resp App. at A2-A4).

> hereby agrees that such representations and warranties shall survive his purchase thereof. The Subscriber hereby agrees to indemnify and hold harmless the Company, the Sellers and agents of each of them from and against any losses, claims, damages, liabilities, expenses (including attorneys' reasonable fees and disbursements), judgments and amounts paid in settlement resulting from the untruth of any of the warranties and representations contained herein, or the breach by the Subscriber of any of the covenants made by him herein. Notwithstanding the foregoing, however, no representation, warranty, acknowledgment, or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

Id. at A78.

The only signatories to the Subscription Agreement were the sellers, Leslie Combs and Brownell Combs, and the subscribers. Petitioners Bryant, Kemper Securities, Charles R. Hembree and the Kincaid firm were neither parties nor signatories to the agreement.

2. The securities fraud lawsuits.

In 1986, respondents filed securities fraud lawsuits, alleging that the Combses, petitioners Hembree, the Kincaid firm, Bryant and Kemper Securities misrepresented and omitted material facts in connection with the sale of Spendthrift stock. Respondents settled with Leslie Combs for $2 million. The district court granted summary judgment in favor of petitioners Bryant and Kemper Securities, and it directed a verdict in favor of petitioners Hembree and the Kincaid firm. The jury returned a verdict in

favor of Brownell Combs. The Ninth Circuit affirmed. McGonigle v. Combs, 968 F.2d 810 (9th Cir. 1992).

In response to the complaint below, petitioners filed compulsory counterclaims for attorney's fees under the Subscription Agreement.[4] The Combses, the actual sellers of the stock, filed no such counterclaims.[5]

C. The decisions below.

Petitioners' claim for attorney's fees under the Subscription Agreement is not, and never has been, based on the loss of any private placement exemption. Rather, it is based solely on the claim that respondents, by alleging misrepresentations and

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4 Petitioners also requested attorneys' fees pursuant to Section 11(e) of the 1933 Securities Act (15 U.S.C. § 77k(e)). The district court denied that request on the ground that respondents' securities fraud lawsuit was neither frivolous nor filed in bad faith. The Ninth Circuit agreed that the lawsuits were neither frivolous nor filed in bad faith, but remanded on the narrow issue of whether the court had considered the Ninth Circuit standard of "bordering on the frivolous" with respect to petitioner Bryant. Layman, 994 F.2d at 1353 & n.7 (Pet App. at A20-A21).

5 Following trial, Brownell Combs requested leave to amend to file a similar compulsory counterclaim but the California district court denied the request. Stratmore, 723 F. Supp. at 459-60, 463-64 (Pet App. at A39-40, A50). One year later, Brownell filed a separate action against respondent Yoshida for attorney's fees under the Subscription Agreement in the United States District Court for the Eastern District of Kentucky. See Combs v. Yoshida, No. 90-131 (E.D. Ky. 1993) (Pet App. at A51-A60). The Kentucky district court, over the strenuous objection of respondent Yoshida, permitted the case to proceed as a separate action despite the compulsory nature of the claim in the original California action.

omissions of material facts in the underlying securities fraud complaint, purportedly breached the representations of the Subscription Agreement.[6]

The district court rejected petitioners' interpretation of the Subscription Agreement, observing that the intent of the indemnification paragraph, as expressly set forth in its first sentence, "is to protect Spendthrift and the selling shareholders from the consequences of a plaintiff being unqualified, or the shares being unsuitable for his investment, and hence the private placement being lost." Stratmore, 723 F. Supp. at 461 (Pet App. at A43).

The district court ruled that, in view of the language on the face of the Subscription Agreement, "[respondents] had little reason to anticipate that the indemnity provision would apply to suits by the buyers themselves against the sellers for securities act violations." Id. at 463 (Pet App. at A49). Accordingly, as a simple matter of contract interpretation, the district court held that:

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6 In considering the summary judgment motions, the district court "assume[d] that the representations or warranties alleged by defendants were breached by plaintiffs." Stratmore, 723 F. Supp at 460 (Pet App. at A42). The Ninth Circuit made the same assumption for purposes of argument. Layman, 994 F.2d at 1350 (Pet App. at A13). Respondents do not agree that there was any breach of the representations or warranties of the Subscription Agreement. For purposes of the summary judgment motion, however, respondents argued below that even assuming a breach, petitioners were not entitled to attorneys' fees.

> [T]he indemnity clause here did not explicitly provide that plaintiffs would be liable for defendants' attorneys' fees in the event of an unsuccessful securities lawsuit by plaintiffs, and the clause therefore may not be enforced in that manner.

Id. (Pet App. at A50).

The Court of Appeals affirmed. Applying California state law of contract interpretation, the Court concluded that:

> [T]he unambiguous expressed intent of the [indemnity] clause is that any investor whose breach of a representation causes the sellers to lose their private placement exemption is obligated to reimburse the sellers for their losses. In our view, a reasonable investor who read the PPM and the subscription agreement would so interpret the indemnification clause.

Layman, 994 F.2d at 1351, 1350 n.3 (footnote omitted) (Pet App. at A15, A13).

The dissenting judge, arguing that the Court had misconstrued the California law of contract interpretation, asserted that "California law is just the opposite" of that applied by the majority. Id. at 1355 (Pet App. at A25). According to the dissent, under California law, a party may submit its interpretation of an agreement to a jury "[e]ven if the language seems susceptible to only one meaning." Id. (Pet App. at A26).

REASONS WHY WRIT SHOULD BE DENIED

I. NO FEDERAL QUESTION IS INVOLVED IN THE CONSTRUCTION OF THE SUBSCRIPTION AGREEMENT.

A. The sole issue presented is one of contract interpretation under state law.

The only issue presented by the petition is whether the Ninth Circuit, in applying California law, properly construed the Subscription Agreement between respondent subscribers and the sellers of Spendthrift stock, Leslie and Brownell Combs. The Ninth Circuit itself framed the issue: "Does the indemnification clause obligate the plaintiffs, who are assumed to have breached their warranties, to pay the attorneys' fees of the defendants that were incurred in defending the plaintiffs' unsuccessful claims?" Layman, 994 F.2d at 1350 (Pet App. at A13).

The Ninth Circuit, upon a review of the express language of the Subscription Agreement, concluded that "the unambiguous expressed intent of the clause is that any investor whose breach of a representation causes the sellers to lose their private placement exemption is obligated to reimburse the sellers for their losses." Id. at 1351 (emphasis added) (Pet App. at A15). "[T]he indemnification required by the clause in this case does not extend

to fees or damages incurred in defending claims brought by the subscribing indemnitor." Id. at 1353 (Pet App. at A19).

The dissenting opinion, upon which petitioners place great reliance, actually underscores the limited nature of the issues decided below. Judge Kozinski argued that, in interpreting the Subscription Agreement, the majority applied law that is the "opposite" of California law. Layman, 994 F.2d at 1355 (Pet App. at A25). Judge Kozinski disagreed that the Subscription Agreement was, on its face, unambiguous, and asked rhetorically "Are we free to interpret the contract--and declare that no rational trier of fact could do otherwise--so as to render this [attorney fee] warranty a nullity?" Id. at 1356 (Pet App. at A27).[7]

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7 The dissent appears to be based in large part upon its misunderstanding of California law. First, under California law, a jury question does not arise simply because a written agreement may be subject to varying interpretations. When, as here, there is no conflict in the extrinsic evidence, "it is 'a judicial function to interpret a written instrument.'" Estate of Dodge, 6 Cal. 3d 311, 318 (1971). Indeed, "[t]he very possibility of . . . conflicting interpretations, far from relieving the appellate court of the responsibility of interpretation, signalizes the necessity of its assuming that responsibility." Parson v. Bristol Development Co., 62 Cal. 2d 861, 866 n.2 (1965). Second, contrary to Judge Kozinski's view that any evidence of meaning is relevant even if the agreement does not appear to be susceptible to that interpretation (see Layman, 994 F.2d at 1355 (Pet App. at A26)), "a court is not required to accept implausible or semantically impermissible claims of meaning." FPI Development, Inc. v. Nekashima, 231 Cal. App. 3d 367, 390 n.10 (1991). For these reasons, a California court expressly criticized Judge Kozinski's "unrestrained view of the California law" of parol evidence, as set forth in a prior opinion. Id. at 389-90 n.10.

For the reasons discussed in the section that follows, respondents submit that the interpretation of the Subscription Agreement by both courts below is correct. But even if the dissent were correct, no issue is presented under the 1933 Securities Act, the 1934 Exchange Act or any other federal law. Although this contract dispute arose in the context of an action under the federal securities, it remains solely a contract dispute--no more, no less.[8]

B. The Ninth Circuit's interpretation of the indemnity provision is correct.

Respondents submit that the above discussion is determinative of this matter: Regardless of whether the Ninth Circuit reached a correct result, no federal issue is presented. Nonetheless, because petitioners present misleading and erroneous argu-

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8 One federal question was decided below. Section 11(e) of the Securities Act of 1933 provides that costs may be awarded for the filing of a securities lawsuit if "the court believes that the suit or the defense thereto have been without merit . . . ." 15 U.S.C. § 77k(e) (Pet App. at A66). The district court denied petitioners' requests for costs under section 11(e), ruling that the claims were neither frivolous nor filed in bad faith. See Stratmore, 723 F. Supp. at 460, n.2 (Pet App. at A40). Petitioner Bryant alone appealed this ruling. The Ninth Circuit agreed that none of the claims against Bryant were frivolous or filed in bad faith, but it remanded on the narrow issue whether the district court had properly considered the Ninth Circuit's "bordering on the frivolous" standard. Layman, 994 F.2d at 1353 & n.7 (Pet App. at A20-A21). Neither the section 11(e) issue, nor any other federal question, is presented to this Court for review.

ments regarding the interpretation issue, respondents will briefly answer those arguments.

The context of the indemnity provision (paragraph 5 of the Subscription Agreement) is critical here. The first page of the PPM, of which the Subscription Agreement is an appendix, provides that:

> [T]he sellers [Leslie and Brownell Combs] will impose certain standards that prospective investors must meet in order to be eligible to purchase the shares. These suitability standards are designed to ensure compliance with Section 4(i) of the Securities Act of 1933 and Regulation D promulgated by the Securities and Exchange Commission thereunder and with the Blue Sky Laws of the states in which the offering will be made.

Layman, 994 F.2d at 1350 (Pet App. at A13).

The indemnity provision itself consists of three sentences which, when read together and in the context of the entire document, show that petitioners' duty to indemnify the Combses and their agents is limited to representations that result in a loss of the registration exemption. This conclusion is based solely upon the express language of the document.

Respondents made representations in the Subscription Agreement for the express purpose of allowing the Combses to claim a registration exemption. The PPM provides that the suitability standards set forth in the Subscription Agreement "are designed to ensure compliance with section 4(1) and Rule 506 promulgated

thereunder."[9] This is expressly confirmed by the first sentence of paragraph 5:

> The foregoing representations and warranties are made by the Subscriber with the intent that they may be relied upon in determining his qualification and suitability to purchase Shares, and the Subscriber hereby agrees that such representations and warranties shall survive his purchases thereof.

Pet App. at A78.

Notably, the second sentence of paragraph 5 contains no agreement that any breach of the representations and warranties by respondents would subject them to payment of costs for filing their own lawsuit based on the sellers' misrepresentations and omissions of material facts in connection with the stock sale. As a practical matter, respondents could not have so agreed. They did not know, and certainly did not believe, that the Combses and their agents misrepresented or omitted material facts. If they had, petitioners would not have invested in the first place.

The third sentence of paragraph 5 is consistent with this point:

> No representation, warranty, acknowledgment, or agreement by the Subscriber made herein shall in any manner be deemed to constitute a waiver of any rights granted to him under Federal or State securities laws.

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9 Indeed, the Ninth Circuit properly noted that "the representations in the subscription agreement track, verbatim, the language of Regulation D." Layman, 994 F.2d at 1351 (Pet App. at A13-A14).

Pet App. at A78. Respondents did not waive their right to file a lawsuit for misrepresentations and omissions of material facts.

Under these circumstances, and in view of the context of the language at issue, the Ninth Circuit was correct in concluding that the second sentence of paragraph 5 is limited to situations involving a loss of the registration exemption. There is no basis upon which to conclude that respondents agreed to the expansive reading advanced by petitioners.

Petitioners, in an attempt to transmute this fact-specific case of contract interpretation into a federal question, assert that the Ninth Circuit relied upon a "special standard of narrow construction against sellers of securities whenever buyers allege federal securities claims." Petition ("Pet.") at i. In support of this assertion, petitioners refer to the Ninth Circuit's citation of the Second Circuit's opinion in Zissu v. Bear Stearns & Co., 805 F.2d 75 (2d Cir. 1986). That citation, however, affords no support to petitioners' position. After utilizing basic principles of contract construction to rule that the Subscription Agreement was unambiguous on its face, the Ninth Circuit observed:

> Our reading of Zissu is that a reference to attorneys' fees is necessary but not sufficient; the crucial element of an indemnification is that it put potential investors on notice that the indemnification is not limited, and instead applies to fees and damages incurred in defending a claim brought by the subscribing indemnitor

herself. The placement of the indemnifying language, as well as the language itself, must reveal its scope.

Layman, 994 F.2d at 1352 (Pet App. at A17). The Ninth Circuit nowhere referred to any "standard of narrow construction against sellers of securities." Petitioners' effort to manufacture a federal question is in vain.

II. THERE IS NO CONFLICT BETWEEN THE CIRCUIT COURTS REGARDING THE CONSTRUCTION OF INDEMNITY FEE PROVISIONS IN PRIVATE PLACEMENT SUBSCRIPTION AGREEMENTS.

The Second Circuit, the only other Circuit Court to interpret an attorneys' fee provision of a subscription agreement, reached the same result as the Ninth Circuit. In Zissu v. Bear, Stearns & Co., 805 F.2d 75 (2d Cir. 1986), an investor who had made representations and warranties in a subscription agreement filed a lawsuit for securities fraud. Id. at 76. The subscription agreement, similar to the one in this case, provided that the investor would indemnify and hold harmless the sellers for any breach of the representations or warranties. Id. at 77. The agreement also provided, just as the one in this case, that the investor did not waive any of his rights under the securities laws. Id.

The defendants prevailed in the underlying action and requested costs, including reasonable attorneys' fees, under the subscription agreement. Id. at 79. The Second Circuit denied the request applying basic principles of contract construction:

> [T]he warranties in question were necessary to exempt the limited partnership from the requirements of the 1933 Act and are so understood by investors. That being the case, the parties had little reason to expect that such warranties might also be the basis for the counterclaim made in the present case.

Id. Based upon the express language of the subscription agreement, and the New York law of contract construction, the Second Circuit concluded "the indemnity provision is not sufficiently specific to hold [the investor] liable for defendant's costs." Id. at 78.

The Ninth Circuit confirmed that the circuit courts are in accord, observing that its contract analysis "comports with [Zissu] the leading case on the application of indemnification clauses." Layman, 994 F.2d at 1351 (Pet App. at A15). Petitioners nonetheless maintain that "the 'prime reason' certiorari is appropriate in this case is the conflict between certain recent circuit opinions." Pet. at 13. In this regard, petitioners refer to Samuels v. Wilder, 871 F.2d 1346 (7th Cir. 1989), which in fact confirms the accord among the circuits that state law is to be applied. In Samuels, the

district court had interpreted a broad indemnity provision in a nominee agreement. Id. at 1348. As the Seventh Circuit observed:

> [A]fter a thorough analysis of applicable New York law, the district court concluded that the indemnity clause required the 'owner' (here the plaintiffs) to pay the litigation costs incurred by [defendant's nominee] when defending this lawsuit.

Id. at 1351. The Seventh Circuit affirmed, concluding that the district court had correctly applied New York law. Id.[10]

The only reported district court decision referred to by petitioners, Barneby v. E.F. Hutton & Co., 587 F. Supp. 829 (M.D. Fla. 1989), is inapposite. There, the district court denied the plaintiff's motion for summary judgment on the defendant's counterclaim for costs under a subscription agreement, ruling that:

> Defendants only seek indemnity for fees and costs incurred in defending against plaintiffs' nonmeritorious claims which have triggered the indemnity clause.

715 F. Supp. at 1520.

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10 Petitioners' reliance on Atari Corp. v. Ernst & Whinney, 981 F.2d 1025 (9th Cir. 1992) and Tartell v. Chelsea Nat'l Bank, 470 F.2d 994 (2nd Cir. 1972) is equally misplaced. The Ninth Circuit properly distinguished Atari, noting that under the language of the broad indemnity clause at issue in the case, "losses caused by an action brought by the indemnitor" were covered. Layman, 994 F.2d at 1353 (Pet App. at A23). In Tartell, the Second Circuit simply issued a one-sentence per curiam decision affirming the district court. 470 F.2d at 994. The district court opinion, applying the applicable New York law of contract construction, concluded that defendant bank was entitled to attorney's fees under the express language of the bank note at issue in the case. Tartell v. Chelsea National Bank, 351 F. Supp. 1071, 1079 (S.D.N.Y. 1972).

Respondents do not dispute that, when securities claims lack merit, in violation of section 11(e), the defendants can be awarded costs. But, that is not present in this case.[11]

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11 Petitioners also rely (Pet., pp. 2-3, 4, 21, 22-24) on the unreported decision of the Kentucky district court in the action brought there by Brownell Combs on the same agreement involved herein. See Combs v. Yoshida, No. 90-131 (E.D. Ky. 1993) (Pet App. at A51-A60). In that decision, the district court held that, because the agreement (in its view) was subject to various interpretations on its face, "the applicability of the indemnity clause is an issue for the trier of fact." Pet App. at A59-A60. Respondents disagree with this conclusion. However, even if it were correct, it is apparent that it results from application of rules of contract interpretation that differ from California's law. See discussion supra, p. 8, n.5. Hence, any "conflict" or "inconsistency" (see Pet. at 21-26) results from federal courts in different districts applying different state law. This is a result inherent in the federal system, not from any conflict in interpretation of federal law.

CONCLUSION

For the reasons stated above, respondents respectfully submit that the petition for writ of certiorari should be denied.

Dated: September 9, 1993.

Respectfully submitted,

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APPENDIX

The Securities Act of 1933, Section 4(1) & (2) (15 U.S.C. § 77d(1) & (2)) (1993):

§ 77d. Exempted transactions.

The provisions of section 5 . . . shall not apply to--

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

* * *

SEC Rules 501, 502 & 506, commonly referred to as Regulation D (17 C.F.R. § 230.501, 502 & 506) (1993):

§ 230.501 Definitions and terms used in Regulation D.

As used in Regulation D (§§ 230.501-230.508), the following terms shall have the meaning indicated:

(a) *Accredited investor.* *Accredited investor* shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency

or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

(2) Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(3) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;

(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;

(5) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;

(6) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;

(7) Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in § 230.506(b)(2)(ii); and

(8) Any entity in which all of the equity owners are accredited investors.

(b) *Affiliate.* An *affiliate* of, or person *affiliated* with, a specified person shall mean a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified.

(c) *Aggregate offering price. Aggregate offering price* shall mean the sum of all cash, services, property, notes, cancellation of debt, or other consideration to be received by an issuer for issuance of its securities. Where securities are being offered for both cash and non-cash consideration, the aggregate offering

price shall be based on the price at which the securities are offered for cash. Any portion of the aggregate offering price attributable to cash received in a foreign currency shall be translated into United States currency at the currency exchange rate in effect at a reasonable time prior to or on the date of the sale of the securities. If securities are not offered for cash, the aggregate offering price shall be based on the value of the consideration as established by bona fide sales of that consideration made within a reasonable time, or, in the absence of sales, on the fair value as determined by an accepted standard. Such valuations of non-cash consideration must be reasonable at the time made.

(d) *Business combination.* *Business combination* shall mean any transaction of the type specified in paragraph (a) of Rule 145 under the Act (17 CFR 230.145) and any transaction involving the acquisition by one issuer, in exchange for all or a part of its own or its parent's stock, of stock of another issuer if, immediately after the acquisition, the acquiring issuer has control of the other issuer (whether or not it had control before the acquisition).

(e) *Calculation of number of purchasers.* For purposes of calculating the number of purchasers under §§ 230.505(b) and 230.506(b) only, the following shall apply:

(1) The following purchasers shall be excluded:

(i) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser;

(ii) Any trust or estate in which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interests);

(iii) Any corporation or other organization of which a purchaser and any of the persons related to him as specified in paragraph (e)(1)(i) or (e)(1)(ii) of this section collectively are beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interests; and

(iv) Any accredited investor.

(2) A corporation, partnership or other entity shall be counted as one purchaser. If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor under paragraph (a)(8) of this section, then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D (§§ 230.501-230.508), except to the extent provided in paragraph (e)(1) of this section.

(3) A non-contributory employee benefit plan within the meaning of Title I of the Employee Retirement Income Security

Act of 1974 shall be counted as one purchaser where the trustee makes all investment decisions for the plan.

(f) *Executive officer.* *Executive officer* shall mean the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy making function, or any other person who performs similar policy making functions for the issuer. Executive officers of subsidiaries may be deemed executive officers of the issuer if they perform such policy making functions for the issuer.

(g) *Issuer.* The definition of the term *issuer* in section 2(4) of the Act shall apply, except that in the case of a proceeding under the Federal Bankruptcy Code (11 U.S.C. 101 *et seq.*), the trustee or debtor in possession shall be considered the issuer in an offering under a plan or reorganization, if the securities are to be issued under the plan.

(h) *Purchaser representative.* *Purchaser representative* shall mean any person who satisfies all of the following conditions or who the issuer reasonably believes satisfies all of the following conditions:

(1) Is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any

class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the purchaser is:

(i) A relative of the purchaser representative by blood, marriage or adoption and not more remote than a first cousin;

(ii) A trust or estate in which the purchaser representative and any persons related to him as specified in paragraph (h)(1)(i) or (h)(1)(iii) of this section collectively have more than 50 percent of the beneficial interest (excluding contingent interest) or of which the purchaser representative serves as trustee, executor, or in any similar capacity; or

(iii) A corporation or other organization of which the purchaser representative and any persons related to him as specified in paragraph (h)(1)(i) or (h)(1)(ii) of this section collectively are the beneficial owners of more than 50 percent of the equity securities (excluding directors' qualifying shares) or equity interest;

(2) Has such knowledge and experience in financial and business matters that he is capable of evaluating, alone, or together with other purchaser representatives of the purchaser, or together with the purchaser, the merits and risks of the prospective investment;

(3) Is acknowledged by the purchaser in writing, during the course of the transaction, to be his purchaser representative in

connection with evaluating the merits and risks of the prospective investment; and

(4) Discloses to the purchaser in writing a reasonable time prior to the sale of securities to that purchaser any material relationship between himself or his affiliates and the issuer or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

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§ 230.502 General conditions to be met.

The following conditions shall be applicable to offers and sales made under Regulation D (§§ 230.501-230.508):

(a) *Integration.* All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation D offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation D, other than those

offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act (17 CFR 230.405).

. . . .

(b) *Information requirements--(1) When information must be furnished.* If the issuer sells securities under § 230.505 or § 230.506 to any purchaser that is not an accredited investor, the issuer shall furnish the information specified in paragraph (b)(2) of this section to such purchaser a reasonable time prior to sale. The issuer is not required to furnish the specified information to purchasers when it sells securities under § 230.504, or to any accredited investor.

(2) *Type of information to be furnished.* (i) If the issuer is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, at a reasonable time prior to the sale of securities the issuer shall furnish to the purchaser the following information, to the extent material to an understanding of the issuer, its business, and the securities being offered:

(A) *Offerings up to $2,000,000.* The same kind of information as would be required in Part II of Form I-A (17 CFR 239.90), except that the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited.

(B) *Offerings up to $7,500,000.* The same kind of information as would be required in Part I of Form S-18 (17 CFR

239.28), except that only the financial statements for the issuer's most recent fiscal year must be certified by an independent public or certified accountant. If Form S-18 is not available to an issuer, then the issuer shall furnish the same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled to use, except that only the financial statements for the most recent two fiscal years prepared in accordance with generally accepted accounting principles shall be furnished and only the financial statements for the issuer's most recent fiscal year shall be certified by an independent public or certified accountant. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

(C) *Offerings over $7,500,000.* The same kind of information as would be required in Part I of a registration statement filed under the Act on the form that the issuer would be entitled

to use. If an issuer, other than a limited partnership, cannot obtain audited financial statements without unreasonable effort or expense, then only the issuer's balance sheet, which shall be dated within 120 days of the start of the offering, must be audited. If the issuer is a limited partnership and cannot obtain the required financial statements without unreasonable effort or expense, it may furnish financial statements that have been prepared on the basis of federal income tax requirements and examined and reported on in accordance with generally accepted auditing standards by an independent public or certified accountant.

(D) If the issuer is a foreign private issuer, the issuer shall disclose the same kind of information required to be included in a registration statement filed under the Act on the form that the issuer would be entitled to use. The financial statements need be certified only to the extent required by paragraph (b)(2)(i) (B) or (C) of this section, as appropriate.

(ii) If the issuer is subject to the reporting requirements of section 13 or 15(d) of the Exchange Act, at a reasonable time prior to the sale of securities the issuer shall furnish to the purchaser the information specified in paragraph (b)(2)(ii)(A) or (B) of this section, and in either event the information specified in paragraph (b)(2)(ii)(C) of this section:

(A) The issuer's annual report to shareholders for the most recent fiscal year, if such annual report meets the requirements of § 240.14a-3 or 240.14c-3 under the Exchange Act, the definitive proxy statement filed in connection with that annual report, and, if requested by the purchaser in writing, a copy of the issuer's most recent Form 10-K (17 CFR 249.310) under the Exchange Act.

(B) The information contained in an annual report on form 10-K under the Exchange Act or in a registration statement on Form S-1 (17 CFR 239.11), Form S-11 (17 CFR 239.18), or Form S-18 (17 CFR 239.28) under the Act or on Form 10 (17 CFR 249.210) under the Exchange Act, whichever filing is the most recent required to be filed.

(C) The information contained in any reports or documents required to be filed by the issuer under sections 13(a), 14(a), 14(c), and 15(d) of the Exchange Act since the distribution or filing of the report or registration statement specified in paragraphs (b)(2)(ii) (A) or (B), and a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs that are not disclosed in the documents furnished.

(D) If the issuer is a foreign private issuer, the issuer may provide in lieu of the information specified in paragraph (b)(2)(ii)

(A) or (B) of this section, the information contained in its most recent filing on Form 20-F or Form F-1 (§ 23931 of the chapter).

(iii) Exhibits required to be filed with the Commission as part of a registration statement or report, other than an annual report to shareholders or parts of that report incorporated by reference in a Form 10-K report, need not be furnished to each purchaser that is not an accredited investor if the contents of material exhibits are identified and such exhibits are made available to a purchaser, upon his written request, a reasonable time prior to his purchase.

(iv) At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under § 230.505 or § 230.506, the issuer shall furnish to the purchaser a brief description in writing of any material written information concerning the offering that has been provided by the issuer to any accredited investor but not previously delivered to such unaccredited purchaser. The issuer shall furnish any portion or all of this information to the purchaser, upon his written request a reasonable time prior to his purchase.

(v) The issuer shall also make available to each purchaser at a reasonable time prior to his purchase of securities in a transaction under § 230.505 or § 230.506 the opportunity to ask questions and receive answers concerning the terms and conditions of

the offering and to obtain any additional information which the issuer possesses or can acquire without unreasonable effort or expense that is necessary to verify the accuracy of information furnished under paragraph (b)(2) (i) or (ii) of this section.

(vi) For business combinations or exchange offers, in addition to information required by Form S-4 (17 CFR 239.25), the issuer shall provide to each purchaser at the time the plan is submitted to security holders, or, with an exchange, during the course of the transaction and prior to sale, written information about any terms or arrangements of the proposed transactions that are materially different from those for all other security holders. For purposes of this subsection, an issuer which is not subject to the reporting requirements of section 13 or 15(d) of the Exchange Act may satisfy the requirements of Part I.B. or C. of Form S-4 by compliance with paragraph (b)(2)(i) of this § 230.502.

(vii) At a reasonable time prior to the sale of securities to any purchaser that is not an accredited investor in a transaction under § 230.505 or § 230.506, the issuer shall advise the purchaser of the limitations on resale in the manner contained in paragraph (d)(2) of this section. Such disclosure may be contained in other materials required to be provided by this paragraph.

(c) *Limitation on manner of offering.* Except as provided in § 230.504(b)(1), neither the issuer nor any person acting on its

behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and

(2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

(d) *Limitations on resale.* Except as provided in § 230.504(b)(1), securities acquired in a transaction under Regulation D shall have the status of securities acquired in a transaction under section 4(2) of the Act and cannot be resold without registration under the Act or an exemption therefrom. The issuer shall exercise reasonable care to assure that the purchasers of the securities are not underwriters within the meaning of section 2(11) of the Act, which reasonable care may be demonstrated by the following:

(1) Reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons;

(2) Written disclosure to each purchaser prior to sale that the securities have not been registered under the Act and, therefore, cannot be resold unless they are registered under the Act or unless an exemption from registration is available; and

(3) Placement of a legend on the certificate or other document that evidences the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities. While taking these actions will establish the requisite reasonable care, it is not the exclusive method to demonstrate such care. Other actions by the issuer may satisfy this provision. In addition, §§ 230.502(b)(2)(vii) and 230.504(b)(2)(ii) require the delivery of written disclosure of the limitations on resale to investors in certain instances.

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§ 230.506 Exemption for limited offers and sales without regard to dollar amount of offering.

(a) *Exemption.* Offers and sales of securities by an issuer that satisfy the conditions in paragraph (b) of this section shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the Act.

(b) *Conditions to be met--(1) General conditions.* To qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of §§ 230.501 and 230.502.

(2) *Specific Conditions--(i) Limitation on number of purchasers.* There are no more than or the issuer reasonably believes

that there are no more that 35 purchasers of securities from the issuer in any offering under this section.

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(ii) *Nature of purchasers.* Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.